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INDUSTRIAL STRATEGIES AND POLICIES IN MALAYSIA SINCE 1959. A case study of manufacturing sector.

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List of Diagrams

ABBREVIATIONS

ADA	-	Accelerated Depreciation Allowance
ERP	-	Effective Rate of Protection
FELDA	-	Federal Land Development Authority
FIDA	-	Federal Industrial Development Authority
FTZ	-	Free Trade Zone
GDP	-	Gross Domestic Product
HEX	-	Hoffmann Export Survey 1974
ITC	-	Investment Tax Credit
ISI	-	Import Substitution Industrialisation
ICA	-	Industrial Coordination Act
IBRD	-	International Bank for Reconstruction and Development
IE	-	Industrial Estates
LC	-	Locational Incentives
LUR	-	Labour Utilisation Relief
MIEL	-	Malaysia Industrial Estate Limited
MIDF	-	Malaysia Industrial Development Finance Limited
NEP	-	New Economic Policy
PS	-	Pioneer Status
PIO	-	Pioneer Industries Ordinance
TAB	-	Tariff Advisory Board

Currency : Malaysia dollar or ringgit = 100 cents, exchange rate on January 1, 1970, £1 = $7.36.

Exchange rate on January 2, 1975, £1 = $5.400.

Exchange rate on January 2, 1980, £1 = $4.8610.

CHAPTER ONE

CHAPTER ONE

BACKGROUND INFORMATION ON MALAYSIA, THE SCOPE AND OBJECTIVES OF THE OF THE DISSERTATION

This chapter presents a brief introductory account on Malaysia's geographical, historical, political and economic background. The scope of the dissertation is outlined in the latter part of the chapter.

I. Background

Geographically, Malaysia occupies a central position within the area commonly known as South East Asia. Malaysia is a federation consisting of thirteen states,with eleven states in Peninsular Malaysia namely Johore, Kedah, Kelantan, Malacca, Negeri Sembilan, Pahang, Penang, Perlis, Selangor, Trengganu and East Malaysia consisting of Sabah and Sarawak which are separated by 640 kilometres of water - the South China Sea. Peninsular Malaya secured independence in 1957 but was joined with Sabah and Sarawak in 1963 to form the Federation of Malaysia.

Malaysia with a total land area of approximately 330, 434 sq. km has a population of about 14.3 million people with an average annual population growth rate (1976 - 1980) of 2.68%. Its population is mainly concentrated in Peninsular Malaysia which consists of 11.8 million people of which 53.9% are Malays, 34.9% Chinese, 10.5% Indians and 0.7% others. Only about 2.3 million people live in East Malaysia. In Sarawak 63.4% are Malays and other indigeneous people, 31% Chinese and 5.6% others. In Sabah 64.1% are designated as 'bumiputra' or indigeneous peoples, 21.5% Chinese and 14.4% others.[1]

On achieving independence from the British in 1957, Malaysia adopted a democratic system of government under a Constitutional Monarchy. The

1. Malaysia - A basic Guide Book for Potential Investors Malaysia Government Publication 1980, p.47.

Head of the State, known as the "Yang di Pertuan Agong", is elected for five years by nine hereditary Malay rulers of the states.

Since independence, successive elections have voted the same Government into power. The ruling party in Malaysia is the National Front which has enjoyed more than two-thirds majority in Parliament.

Since gaining independence 1957 Malaysia has stepped up its development effort through a series of development plans to accelerate economic growth and to diversify the economy. The agricultural sector (including fishing and forestry) continues to be the mainstay of the economy. In 1980, this sector accounted for about 22% of the Gross Domestic Product of the Country and about 40.6% of total labour force was employed in the agricultural sector. Rubber is still an important crop in Malaysia accounting for almost 39.5% of the total world production but efforts to diversify the agricultural sector have led Malaysia to become the world's largest producer of palm oil accounting for almost 57% of total World production. Apart from being the World's leading producer of rubber and palm oil, Malaysia is also responsible for 37% of the World's production of tropical hardwoods as well as the major producer of pepper. Malaysia is still the World's leading producer of tin but its importance to the domestic economy is gradually declining. Recently, the Country has also emerged as a producer and exporter of crude petroleum.

Notwithstanding the importance of the agricultural sector to the economy, increasing emphasis is directed towards the development of the manufacturing sector in order to diversify the economy as well as to provide employment to a growing labour force. In 1980 the manufacturing sector contributed about 21% of the Gross Domestic Product (GDP) and became the fastest growing sector, experiencing an annual average growth rate of 14.3% in the last three years.

II Scope and Objectives of the Dissertation

The scope of this dissertation is strictly focussed on the manufacturing sector as it generally accepted that this sector is one of the most important components of overall economic development in the Third World. Malaysia and most other developing countries have encouraged the growth of manufacturing sector for several reasons including potential foreign exchange saving where imports would be produced locally for the domestic market. Under-employment and unemployment are one of the major problems in a country experiencing rapid population growth and these problems could be lessened by the advance of industrialisation. Moreover, low technological levels in most developing countries including Malaysia, can be raised by introducing widespread industrial activity.

In the present development plan - the Fourth Malaysia Plan (1981 - 1985), the manufacturing sector is still expected to play a strategic role in the process of economic development as well as to achieve the objectives of the New Economic Policy (NEP). This is clearly indicated by the following extract.

> "Manufacturing continues to play a strategic role in the achievement of the New Economic Policy (NEP)"[1] and "the government has in fact designated the manufacturing sector as the key sector of the economy in formulating its long-term economic development plans"[2]

The general objective of this dissertation is to examine the potential for the future growth of the manufacturing sector in Malaysia within the

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1. Fourth Malaysia Plan (1981 - 1985)
   Malaysia Government Publication, p.293.
2. Investment in Malaysia, Policies and Procedures
   Malaysia Government Publication in 1981, p.4.

broad policy framework of other government objectives such as "eradicating poverty by raising the income levels"[1], balanced industrial growth amongst the regions, and technology transfer. The mechanisms used to promote industrial development were many but the major ones include fiscal incentives, tariff protection and the establishment of industrial estates, which are examined in detail. Whilst these policies undoubtedly stimulated rapid growth in the manufacturing sector, they were also responsible for some undesirable effects such as the heavy concentration of industry in a few select areas. Perhaps even greater criticism can be levelled at the capital - intensive nature of the industries which developed in response to various government policies, and it is now recognised that a more positive approach is required to encourage a manufacturing technology which is more appropriate to the factor proportions of the country, with special emphasis upon employment generation.

Unless otherwise stated the data in this dissertation refer to West Malaysia. Whilst there are now firm indications that Sarawak and Sabah will develop manufacturing capability, they have to date experienced only a minimal amount of industrial activity and are therefore excluded from most statistical data.

Chapter 2 traces the development of manufacturing sector from the initial strategy of import substitution to the presently favoured export led growth strategy. Other disappointing facets such as regional development imbalances, ownership and control of the manufacturing sector, employment generation and size distribution are also discussed in Chapter 2.

1. See for detail New Economic Policy (NEP) in footnote Chapter 3.

Chapter 3, examines the development of government industrial policies in the manufacturing sector since independence. Towards the end of the 1960's the Malaysian government became aware that the pace and direction of industrial development was not in accord with its aspirations, it therefore took an increasingly interventionist approach in an attempt to make manufacturing activity follow more closely the guidelines established by the government. This approach is outlined in Chapter 4, with particular attention being directed to fiscal incentives, tariffs and industrial estates.

Potential future growth of manufacturing not only lies in the creation of integrated industrialisation, skill development, manpower training etc. but also on the prospects for export expansion of the manufactured goods and this is examined in detail in Chapter 5.

CHAPTER TWO

CHAPTER TWO

DEVELOPMENT OF MANUFACTURING SECTOR SINCE 1957

This chapter outlines the development pattern of the manufacturing activity from before independence to the present decade. It is divided into three sections. Section I describes the development of manufacturing activity in the pre-independence period. Section II describes the development of manufacturing activity from 1957 to 1969 - mainly an import substitution approach. Finally section III details the development pattern of manufacturing activity from import substitution (IS) to export expansion from period of 1970 to 1980.

I. Pre-Independence Period

Industrial activity in the pre-independence period was limited to the extractive industries including the mining and plantation industries. This was a typical colonial pattern of economic activity where primary commodities were exported to the metropolitan country of Britain in return for manufactured imports. Although manufacturing activity in the pre-independence period existed its contribution to the economy was very insignificant. By International Bank for Reconstruction and Development (IBRD) classification, the most important industrial activities in 1947 were handicraft industries, primary processing and engineering activities. All these industries were small-scale based on family workers and produced only a small amount of industrial output. These industries were well distributed throughout West Malaysia and employed quite considerable numbers of workers who accounted for up to 6.7 per cent of the active labour force in West Malaysia. Ownership patterns of these simple types of manufacturing activities during the pre-independence period are difficult to assess owing to the inadequacy of data.

II Pattern of Manufacturing Activity - 1957 to 1969

At independence Malaysia displayed characteristics associated with colonialism. In common with most other newly independent developing countries, Malaysia embarked upon an industrialisation strategy. There were various reasons for such a strategy including the S. Kuznets and H.B. Chenery argument that industrialisation can be the basis for development particularly in the long-run period. It also enables a country to be less dependent on the export of primary commodities which largely fluctuate in price and cause uncertainty in foreign earnings. Industrialisation creates opportunities for labour force training which will in turn have external effects on the whole economy. Finally rapid industrialisation is able to solve unemployment problems over a long-run period. Some of the above reasons of industrialisation are to be found in the International Bank for Reconstruction and Development (IBRD) Report (1955) and Working Party Report i.e. which basically stressed the need to diversify the economy and to solve the unemployment problems.

There was not much progress of manufacturing activity during the early independence period. The development of manufacturing activity during the early independence period was characterised by poor and uncoordinated planning. A consequence of which was the indiscriminate development of manufacturing activity. For instance there was wasteful competition between firms producing similar products which competed for a very limited market. Wasteful competition can be observed from the existence of two sweetened condensed milk firms, five pharmaceutical firms, five paint firms and three watch firms.[1] The slow development of manufacturing activity at early independence period is also partly

1. See Wheelwright, Edward Lawrence, Industrialisation in Malaysia, Melbourne, 1965.

attributable to the open system which allowed British Commonwealth manufactured goods free access without being subjected to tariffs. This preferential system was clearly revealed in the official Tariff Schedule published in 1957 where the imported goods from non British Commonwealth Countries were subjected to 10-20% of tariff protection.*

*Initial industrial strategy was based on the International Bank for Reconstruction and Development (IBRD) Report and Working Party which aimed to stimulate the development of the manufacturing sector. The industrial strategy policies were first followed by foreigners rather than the local investors due to several reasons, which included lack of experience in manufacturing activity, greater preference to invest in the retail trade, property development and extractive industries and unwillingness of foreign and local investors to merge in the form of joint venture. Major foreign investors came from Europe, United States of America, Singapore, Hong Kong, Indonesia, Pakistan, Bahamas, Formosa, India and Japan.

From the period since independence to 1969, industrial strategy was based on the import substitution (IS) pattern, such a pattern can be traced from the structure of Malaysia's imported goods. As a consequence, whilst consumer goods as a proportion of total imports significantly fell fr 52% in 1965 to 20% in 1970, investment goods and intermediate goods increased in their share from 14.3% in 1960 to 28.2 per cent in 1970 (see table 2.1).

Table 2.1 - Machinery and Equipment as a Proportion of Total Merchandise Imports (in percentages)

Countries	1960	1961	1970	1973
Malaysia	14.3	21.4	28.2	-
Thailand	25.0	30.7	35.6	31.7
Singapore	7.0	14.4	22.8	28.0
Philippines	36.0	31.3	35.4	29.0
Indonesia	17.1	25.5	34.3	-

Source: World Bank Tables, 1976.

The two pillars upon which Import Substitution Industrialisation (ISI) strategy was based were tariff protection and tax incentives. Tax incentives were granted under pioneer status policy which accounted for the growth of pioneer establishments which then became the leading edge of the manufacturing activity. The number of firms granted pioneer status not only increased from year to year as shown in table 2.2 but it also attracted more large scale enterprises than medium or small-sized establishments. Based on table 2.2, total number of firms under pioneer status in 1959 was only 18 but increased to 146 in 1968. Although the absolute number of establishments under pioneer status were fairly small their contribution to manufacturing output, value added and capital stock was significant, but in terms of employment generation their contribution was slightly lower. Particularly before mid 1970's the contribution of pioneer establishments to employment generation was relatively inconsistent with government aspirations to create more jobs. The reason why pioneer establishments generated less labour input was due to their highly capital intensive nature.

Table 2.2 - Growth of the Pioneer Sector, 1959 - 1971

	No.	% of Manuf.	Output (M$'000)	% of Manuf	Value Added (M$'000)	% of Manuf.	Fixed Capital (M$'000)	% of Manuf.	Employment No.	% of Manuf.	Salaries & Wages (M$'000)	% of Manuf.
1959	18	0.4	10,671	0.8	4,305	1.5	n.a.	n.a.	1,296	2.1	1.656	1.8
1963	85	1.0	195,424	11.6	72,328	17.2	n.a.	n.a.	7,171	8.2	16,586	10.8
1968	146	1.6	895,126	29.3	278,274	32.2	449,027	50.4	23,115	17.7	63,255	23.7
1971	246	n.a.	1,393,361	33.5	450,933	35.6	699,947	54.3	43,624	28.8	106,866	29.5

Manufacturing excludes on-estate processing.

Manuf. = manufacturing
n.a. = Not available

Source: Hoffmann, L. and Ee, T.S., Industrial Growth and Employment and Foreign Investment in Peninsular Malaysia, p.37, Table III.1

Through the pioneer industry policy, efforts to diversify the industrial base were relatively successful in the period 1957 to 1969. The number of industries set up under pioneer status increased and included food products, chemical products, basic metals, non-metallic goods, mineral products, fabricated metal and miscellaneous products (see table 2.3).

Other forms of structural characteristics of manufacturing activity before 1969 can be traced from the ownership, size distribution and regional location.

Ownership pattern of economic development can be easily traced after the immediate independence period. This was characterised by ethnic imbalances along different economic function. Based on table 2.4 Malays were dominant in the traditional and backward agricultural sector which was in direct contrast to the Chinese and Indians who were relatively dispersed in different sectors. About 70% of total Malaysian Chinese were in the manufacturing sector, whilst only about 19% of total Malays and 11% of total Indians were involved in the manufacturing activity. This pattern led to the process of restructuring of ethnic imbalances along the New Economic Policy (NEP) objectives which is examined in Chapter 3.

Generally, the local investors involved in the manufacturing activity before 1969 were the Malaysian Chinese. Most often the Malaysian Chinese were predominant in the small scale establishments whilst the large establishment were mainly foreign owned. Based on table 2.5 about 87% of total industrial establishments were small-scale[1] in 1959. In contrast, the large scale establishments only accounted for about

1. less than 20 full time workers employed in the industrial establishment was classified as a small-scale industry according to Hoffmann Classification.

TABLE 2.3

TYPE OF INDUSTRIES UNDER PIONEER STATUS IN 1963 and 1968 (IN ABSOLUTE NUMBERS)

TYPES OF UNDUSTRY	1963/TOTAL NUMBER OF P.S.	1968/TOTAL NUMBER OF P.S.
Food Industry	12	23
Chemical and Chemical Product Industry	22	31
Basic Metals	3	5
Non Metallic Products	5	7
Fabricated Metal Products	12	14
Miscellencous Industries	8	12

Source: adopted from table 45, 46, 49, 50 and 51 from V.V. Bhanoji Rao - Malaysia Development and Policy 1947-1971. Singapore University Press 1980, p 106-121

P.S. = Pioneer Status

TABLE 2.4

DISTRIBUTION OF EMPLOYMENT BY ETHNIC GROUP, 1947, (IN PERCENTAGES)

SECTOR	MALAYS %	CHINESE %	INDIANS & OTHERS %	TOTAL '000
1. Agriculture	57	30	13	889
(a) peasant	70	27	3	508
(Rice)	(88)	(10)	(2)	(333)
(b) Rubber	39	33	28	381
2. Mining	14	71	15	39
3. Manufacturing	19	70	11	125
4. Services	27	48	25	405
5. Government	54	11	35	105
Total Employment	44	40	16	1,565

Source: G. D. Ness, Bureaucracy and Rural Development in Malaysia. University of California Press, 1967, p.30

Table 2.5 - Distribution of Employment by Size of Establishments

1959

Size of Group in terms of Full-time Employment	Establishments		Gross Output		Paid Employees		Salaries & Wages	
	(No.)	%	(M$'000)	%	(No.)	%	(M$'000)	%
0	1,026	20.50	9,115	0.72	874	1.41	410	0.44
1-4	1,916	38.28	60,345	4.78	5,705	9.26	6,166	6.92
5-9	753	15.04	97,301	7.72	5,525	8.96	7,051	7.82
10-19	639	12.76	124,978	9.91	9,603	15.59	13,153	14.63
20-29	275	5.49	90,582	7.18	6,729	10.92	9,995	11.17
30-49	183	3.65	119,829	9.50	7,177	11.65	10,324	11.50
50-99	133	2.65	267,119	21.19	9,149	14.85	14,927	16.64
100-199	49	0.97	222,603	17.66	6,417	10.41	10,408	11.62
200-499	25	0.49	232,776	18.46	7,325	11.89	11,405	12.73
500+	5	0.09	35,472	2.80	3,093	5.02	5,710	6.36
Total	5,004	100.00	1,260,120	100.00	61,597	100.0	89,549	100.00
Under 20 Employees	4,334	86.59	291,739	23.13	21,707	35.22	26,780	29.81
Over 100 Employees	79	1.57	490,851	38.94	16,835	27.33	27,523	30.73

Source: Census of Manufacturing, Federation of Malaya, 1959 or L. Hoffmann and Tan Siew Ee, Table II, 1,p.17, Industrial Growth, Employment and Foreign Investment in Peninsular Malaysia, Kuala Lumpur, Oxford University Press, 1980, Table II.1, p.17.

Table 2.6 - West Malaysia - Regional Distribution of Manufacturing Establishments and Other Selected Data

1959

States	Establishments		Gross Output		Paid Employees*		Salaries & Wages	
	(No.)	%	(M$'000)	%	(No.)	%	(M$'000)	%
1. Johore	610	12.19	238,782	18.94	10,387	16.86	15,742	17.57
2. Kedah	517	10.33	126,175	10.01	4,990	8.10	6,794	7.59
3. Kelantan	194	3.87	18,841	1.49	2,211	3.58	2,081	2.32
4. Malacca	178	3.55	55,245	4.38	1,786	2.89	2,494	2.78
5. Negri Sembilan	257	5.13	69,504	5.51	2,809	4.56	4,345	4.85
6. Pahang	259	5.17	17,633	1.39	1,393	2.26	2,113	2.35
7. Penang	724	14.46	158,361	12.56	7,333	11.90	10,054	11.22
8. Perak	1,113	22.24	238,153	18.89	10,785	17.50	14,134	15.78
9. Perlis	44	0.87	7,053	0.55	353	0.57	466	0.52
10. Selangor	1,077	21.52	326,540	25.91	18,879	30.64	30,576	34.14
11. Trengganu	51	1.01	3,833	0.30	553	0.89	750	0.83
West Malaysia	5,004	100.00	1,260,120	100.00	61,597	100.00	89,549	100.00
Urbanised states(-)1-7+8+10(+)1	2,914 3,524	58.22 70.41	723,054 961,836	57.36 76.30	36,997 47,384	60.04 76.90	54,764 70,506	61.14 78.71
Other states	1,480	29.59	298,284	23.70	14,213	23.10	19,043	21.29

Sources: Survey of Manufacturing Industries, 1959 Kuala Lumpur, or see Hoffmann, Lutz - Industrial Growth Employment and Foreign Investment in Peninsular Malaysia, Kuala Lumpur, Oxford University Press, 1980, p.23, Table II.3.

1.57 per cent of total industrial establishments in 1959. Small-scale establishments generated a relatively greater employment share although industrial output was slightly lower than the large-scale establishments. For instance in 1959 small scale establishments accounted for only 23% of gross output compared to large-scale establishments which generated about 39% of gross output. But large scale establishments contributed relatively less employment, accounting for only 27% of total employment compared to the small scale establishments which accounted for 35% of total employment.

Within the period of 1957 to 1969, the industrial growth pattern was characterised by uneven regional development. This feature is common to many other developing countries, where rapid urbanisation and economic development were unevenly distributed. Malaysia's regional development is biased toward the West Coast of Pensinular Malaysia since most of the rapid economic development and urbanisation has taken place in four major states - Penang, Selangor, Perak and Johore. As early as 1959 these four states accounted for more than 75% of gross output and employment shares (see table 2.6).

III Pattern of Manufacturing Activity - 1970 to 1980's

From 1968 industrial development efforts were intensified and the government adopted a more positive and strategic role, with a willingness to actively participate in the manufacturing sector if it was deemed necessary. This change of policy was in response to the growing realisation of the government that Malaysia had reached a stage where most opportunities for import substitution had been exhausted, and that in order to maintain the momentum of economic growth new strategies were essential. Measures to stimulate export oriented industries can be traced as early as 1970. The change in strategy resulted in the rapid export expansion of manufactured goods, with an average growth rate at 26.2% per annum. Table 2.7 shows how manufactured exports share in total commodity exports almost doubled from 11% in 1970 to 20.6% in 1980. Consequently, as manufactured exports increased, the Malaysian principal export primary commodities i.e. tin and natural rubber have relatively declined in importance. This was largely due to the government's

Table 2.7 - Malaysia: Major Commodity Exports 1970-80 ($ Million)

Commodity	1970		1980		Av.annual growth rate (%)1971-80
	$	%	$	%	
Rubber	1724	33.4	4860	17.1	10.9
Tin	1013	19.6	2504	8.8	9.5
Saw logs	643	12.5	2435	8.6	14.2
Sawn timber	199	3.9	1221	4.3	19.9
Palm oil	264	5.1	2576	9.1	25.6
Crude petroleum	164	3.2	7200	25.3	46.0
Copper	-	-	113	0.4	-
Pepper	59	1.1	136	0.5	8.7
Canned Pineapple	43	0.8	72	0.2	5.3
Cocoa	-	-	189	0.7	-
Manufactures	572	11.1	5865	20.6	26.2
Other Commodity Exports	482	9.3	1274	4.4	10.2
Total gross Commodity exports	5163	100.0	28,445	100.0	18.6

Source: Fourth Malaysia Plan 1981-1985 -A Review of progress and Summary of Targets, Strategies and Programmes, Page 5, Table 1, Malaysia Government Publication 1980.

efforts to diversify the economy through the growth of manufacturing activity. Table 2.8 indicates some of the main areas of manufacturing growth in the 1970s. Exports of plywood, veneer and blockboards increased at a rate of 12.8% per annum. This stimulated the overall growth of the

Table 2.8 - Peninsular Malaysia: Value-Added Growth in Manufacturing 1970-80

	Share(%)			Average Annual growth rate(%)		
	1970	1975	1980	1971-75	1976-80	1971-80
Food products	15.3	10.9	9.3	2.1	7.1	4.0
Oils and fats	6.3	12.9	14.1	26.0	17.1	22.6
Beverages and tobacco	12.1	10.9	9.9	6.9	9.8	8.0
Textiles	2.1	2.5	3.0	13.3	19.7	15.7
Wood and wood products	12.4	12.1	12.0	8.7	13.0	10.3
Paper and printing	1.0	0.9	1.0	7.6	17.3	11.1
Industrial Chemicals	3.3	2.3	2.0	2.0	7.0	3.8
Chemical products	6.0	5.4	5.1	6.5	11.2	8.3
Petroleum products	4.2	3.1	3.5	3.5	17.0	8.3
Rubber products	6.7	5.5	4.5	5.5	5.6	5.6
Cement	5.4	4.9	5.2	7.0	15.2	10.0
Non-metallic	2.0	1.6	1.7	4.7	14.7	8.3
Basic metal	3.1	3.2	3.6	10.3	11.8	10.8
Fabricated metal	4.6	4.2	4.5	7.2	16.2	10.5
Electrical machinery	2.9	3.0	3.4	10.8	17.6	13.3
Transport equipment	5.3	5.2	4.9	8.6	11.6	9.7
Other manufactures	7.3	11.4	12.4	36.4	16.3	28.5
Total manufacturing	100.0	100.0	100.0	11.6	13.5	12.5

Source: Fourth Malaysia Plan 1981-1985, extracted from Table 16.1 p.294, Malaysia Government Publication 1981.

wood products industry to 10.3% per annum and accounted for total value added of 12% in 1980. Rubber products were increasing exports to the overseas markets such as household, surgical gloves, heavy duty tyres and medical equipment. Value added growth of rubber products by 1980 averaged 5.6% per annum. Textiles exports increased by 26% and resulted in the overall growth of 16% per annum. Total share of textile to manufacturing sector have also increased from 2.1% in 1970 and 2.5% in 1975 to 3.0% in 1980. The share of textile output for export markets increased from 23% in 1970 to about 50% by 1980. Electrical machinery grew at the average of 13.3% per annum. Within the electrical machinery, electronics grew at a spectacular rate of 69% per annum to increase its share in manufactured exports from 1.8% in 1970 to 37% in 1980. Table 2.8 also suggests that import substitution on consumer goods reached its saturation point. For instance food products share to value added growth in the manufacturing sector declined from 15.3% in 1970, 10.9% in 1975, to 9.3% in 1980. Nevertheless, the overall growth of value-added in the manufacturing sector increased from 11.6% per annum in 1971-1975 to 13.5% per annum in 1976 to 1980.

In the decade of the 1970's manufacturing activity proved to be the most dynamic sector of the economy and acted as a catalyst or 'engine of growth' to stimulate the development process. Table 2.9 shows a significant change in the structure of the economy between 1970 and 1980. Manufacturing achieved the highest rate of growth i.e. 13.5% in 1976 to 1980 which enabled it to increase its contribution to Gross Domestic Product (GDP) from 13.4% in 1970 to 16.4% and 20.5% in 1975 and 1980 respectively. Whilst manufacturing sector gained in its importance, the agricultural sector's share to Gross Domestic Product (GDP) declined from 30.8% in 1970 to 27.7% and 22% in 1975 and 1980 respectively.

Table 2.9 - Malaysia:Gross Domestic Product by Sector or Origin, 1970-80
($ million in 1970 prices)

Sector	1970	1975	1980	Average Annual Growth rate(%) 1971-75	1976-80	1971-80	Share of GDP (%) 1970	1975	1980
Agriculture, forestry and fishing	3,797	4,804	5,809	4.8	3.9	4.3	30.8	27.7	22.2
Mining and quarrying	778	792	1,214	0.4	8.9	4.6	6.3	4.6	4.6
Manufacturing	1,650	2,850	5,374	11.6	13.5	12.5	13.4	16.4	20.5
Construction	475	654	1,186	6.6	12.6	9.6	3.9	3.8	4.5
Electricity, gas and water	229	365	592	9.8	10.2	10.0	1.9	2.1	2.3
Transport, storage and Communications	581	1,071	1,696	13.0	9.6	11.3	4.7	6.2	6.5
Wholesale and retail trade, hotels and restaurants	1,633	2,219	3,295	6.3	8.2	7.3	13.3	12.8	12.6
Finance, insurance, real estate and business services	1,036	1,468	2,155	7.2	8.0	7.6	8.4	8.5	8.2
Government services	1,367	2,210	3,398	10.1	9.0	9.5	11.1	12.7	13.0
Other services	306	478	657	9.3	6.6	7.9	2.5	2.8	2.5
Less: imputed bank service charges	117	211	308	-	-	-	-	-	-
Plus: import duties	573	665	1,120	-	-	-	-	-	-
Equals:Gross domestic product at purchasers' value	12,308	17,365	26,188	7.1	8.6	7.8	-	-	-

Source: Fourth Malaysia Plan 1981-1985, extracted from Table 2-1, p.11, Malaysia Government Publication 1980.

Within the period of mid 1970's to 1980, the manufacturing sector generated considerable employment opportunities. It can be seen from table 2.10 that the growth rate of employment generated by manufacturing sector was the highest i.e. 7.6% per annum from 1971 to 1980. However, the agricultural sector contributed less than 2% per annum to the employment growth rate within the same period. As a consequence, the agricultural employment share decreased substantially from 51% in 1970 to 41% in 1980. As reported by the Fourth Malaysia Plan (1981-1985) net employment created by the manufacturing sector increased to 416,000 which amounted for about 25% of total new employment. Whilst agricultural sector employment shares declined, the manufacturing sector's employment share increased from 11% in 1970, to 14% and 16% in 1975 and 1980 respectively.

The growth of employment created in the manufacturing sector was attributable to several factors. First, increases of manufacturing value added at 13.5% per annum in 1976-1980 (see table 2.8). Second, government measures to increase labour intensive industries such as electrical machinery and textiles(Clothing) which increased their workforces at average annual rates of 22% and 13% respectively. Other types of labour intensive industries included wood and rubber products which contributed 8% and 6% per annum. Finally, a strong overseas demand especially in the electronics components industry permitted high growth rates.

From the 1970's the manufacturing sector tended to create more employment opportunities than in the previous decade of the 1960s. To some extent this was directly a result of the change of strategy which directed more attention to labour intensive export oriented industries. The granting of pioneer status to these types of industry stimulated

Table 2.10 - Malaysia: Employment Estimates by Sector, 1970-80

Sector	1970 Estimated Employment ('000)	1970 Share of total (%)	1975 Estimated Employment ('000)	1975 Share of total (%)	1980 Estimated Employment ('000)	1980 Share of total (%)	Average Annual growth rate (%) 1971-75	1976-80	1971-80
Agriculture, forestry and fishing	1,714.6	50.5	1,923.5	45.3	2,066.9	40.6	2.3	1.5	1.9
Mining and quarrying	88.6	2.6	88.3	2.1	89.6	1.7	-0.1	0.3	0.1
Manufacturing	386.5	11.4	572.0	13.5	803.1	15.8	8.2	7.0	7.6
Construction	136.7	4.0	187.8	4.4	262.8	5.2	6.6	7.0	6.8
Electricity, gas and water	26.5	0.8	33.2	0.8	49.5	1.0	4.6	8.3	6.5
Transport, storage and communications	115.1	3.4	165.5	3.9	193.2	3.8	7.5	3.1	5.3
Wholesale and retail trade, hotels and restaurants	371.1	10.9	503.4	11.8	648.5	12.7	6.3	5.2	5.7
Finance, insurance, real estate and business services	31.5	0.9	40.7	0.9	52.1	1.0	5.3	5.1	5.2
Government services	396.6	11.7	555.8	13.1	710.1	13.9	7.0	5.0	6.0
Other Services	128.7	3.8	176.9	4.2	217.7	4.3	6.6	4.2	5.4
	3,395.9	100.0	4,247.1	100.0	5,093.5	100.0	4.6	3.7	4.1
Population	10,776.9		12,449.9		14,261.2				
Labour Force	3,681.9		4,538.8		5,380.0				
Unemployment	286.0		291.7		286.5				
Unemployment rate (%)	7.8		6.4		5.3				

Source: Fourth Malaysia Plan 1981-1985, extracted from Table 4-6, p.81, Malaysia Government Publication 1980.

employment generation within the manufacturing sector. Not only did absolute numbers of pioneer establishments increase from 18 in 1959 to 210 in 1970 and even more to 473 in 1978, but they generated an average of 14,200 new jobs annually. As such pioneer industries employment share in the manufacturing sector increased from 10% in 1970 to 23% in 1978.[1]

In the period of 1970 to 1980 decade, there were also changes in the ownership and size distribution pattern. Based on table 2.11 foreign ownership appears to be high in the Malaysian economy. About 61% of share capital in the economy was dominated by foreign ownership. The most dynamic sector i.e. manufacturing was also dominated by foreign investors who accounted for about 60%. Modern agriculture, mining and wholesale activities form the highest foreign ownership. This indicated a restructuring policy under New Economic Policy to change the pattern of ownership of capital in the corporate sector by 1990 such that Malaysians own and manage 70%, with Malays and other indigeneous people accounting for at least 30%. The restructuring pattern of ownership is understandable for the Malaysian government to ensure political stability which is another important factor for further economic development.

As industrial development has proceeded in Malaysia there has been a marked change in the importance of industries in relation to size and ownership. For instance the small scale establishments which employ less than 20 full time workers experienced a rapid decline in the employment and output shares. In 1959, about 23% and 35% of industrial output and employment shares respectively were accounted for by small

1. See Fourth Malaysia Plan (1981-1985), Malaysian Government Publication 1980.

Table 2.11 - Foreign Ownership in the Malaysian Economy, 1970

	Share Capital		Value of Fixed Assets	
	M$'000	Foreign %	M$'000	Foreign %
Agriculture	(1,432,400)	(75.4)	(14,901,620*)	(25.4)
Rubber	1,134,163	77.7	10,890,000	20.4
Oil Palm, Coconut, Tea	298,237	66.8		
Oil Palm			2,945,810	30.3
Coconut			1,051,550	6.7
Tea			14,260	54.8
Mining	(543,497)	(72.5)	(311,600)	(55.1)
Tin	434,477	71.5		
Other	109,020	76.4		
Manufacturing	1,348,245	59.6	1,128,400	51.0
Construction	58,419	34.1	63,500	5.9
Transport	81,887	12.0	(n.a)	
Trade	(605,164)	(63.6)	(n.a)	
Wholesale	450,593	70.1		
Retail	154,571	44.5		
Financial Sector	(636,850)	(52.3)	(n.a)	
Banks	93,549	35.2		
Insurance	7,670	55.3		
Other	536,631	55.2		
Other Industries	582,516	31.4	(n.a)	
Total	5,288,978	60.7	(16,405,120)	(27.6)

n.a. = not available

*Source: L. Hoffmann, Tan Siew Ee, Table VII.I, page 215, Industrial Growth, Employment and Foreign Investment in Peninsular Malaysia, Oxford University Press, 1980.

Table 2.12 - Distribution of Employment by Size of Establishments

1971

Size of Group in terms of Full-time Employment	Establishments		Gross Output		Paid Employees		Salaries & Wages	
	(No.)	%	(M$'000)	%	(No.)	%	(M$'000)	%
0	65	1.93	3,494	0.08	75	0.05	41	0.02
1-4	201	5.96	19,491	0.47	860	0.51	949	0.26
5-9	671	19.90	89,827	2.16	5,168	3.05	7,525	2.07
10-19	803	23.81	263,042	6.32	11,953	7.06	19,342	3.33
20-29	434	12.87	189,653	4.55	11,230	6.64	18,777	5.17
30-49	447	13.26	348,259	8.36	17,377	10.27	32,531	8.96
50-99	384	11.39	521,680	12.53	26,852	15.87	57,474	15.84
100-199	199	5.90	829,481	19.92	27,746	16.40	69,039	19.03
200-499	136	4.03	1,157,259	27.79	42,201	24.94	91,209	25.14
500+	32	0.95	741,962	17.82	25,740	15.21	65,981	18.18
Total	3,372	100.00	4,164,149	100.00	169.202	100.00	362,867	100.00
Under 20 employees	1,740	51.60	375,854	9.03	18,056	10.67	27,857	7.68
Over 100 employees	367	10.88	2,728,702	65.53	95,687	56.55	226,229	62.35

Sources: Survey of Manufacturing, West Malaysia, Vol. 1, 1971

or L. Hoffmann and Tan Siew Ee, Industrial Growth, Employment and Foreign Investment in Pensinular Malaysia, Kuala Lumpur, Oxford University Press, 1980, p.17, Table II.1.

Table 2.13 - West Malaysia - Regional Distribution of Manufacturing Establishments and Other Selected Data

1971

States	Establishments		Gross Output		Paid Employees*		Salaries & Wages	
	(No.)	%	(M$'000)	%	(No.)	%	(M$'000)	%
1. Johore	457	13.56	566,884	13.6	28,521	16.8	53,034	14.61
2. Kedah	178	5.27	158,781	3.8	5,906	3.5	9.855	2.72
3. Kelantan	109	3.24	46,156	1.1	3,519	2.1	4,509	1.24
4. Malacca	103	3.05	92,287	2.2	3,736	2.2	5,803	1.60
5. Negri Sembilan	118	3.49	295,309	7.1	5,198	3.1	14,374	3.96
6. Pahang	129	3.83	86,977	2.1	7,140	4.2	14,592	4.02
7. Penang	473	14.03	471,545	11.3	20,285	12.0	34,251	9.44
8. Perak	576	17.08	423,561	10.2	24,476	14.5	41,574	11.46
9. Perlis	11	0.32	9,192	0.2	231	0.1	371	0.10
10. Selangor	1,167	34.60	1,993,902	47.9	68,025	40.2	180,651	49.78
11. Trengganu	51	1.51	19,554	0.5	2,163	1.3	3,852	1.07
West Malaysia	3,372	100.00	4,164,149	100.00	169,202	100.0	362,867	100.00
Urbanised states(-)1	2,216	65.71	889,919	69.4	112,786	66.6	256,476	70.68
7+8+10(+)1	2,673	79.27	3,455,892	83.0	141,307	83.5	309,510	85.29
Other States	699	20.73	708,257	17.0	27,895	16.5	53,357	14.71

* include part-time employees.

Sources: Survey of Manufacturing Industries, 1971, Vol. 1, Kuala Lumpur

or L. Hoffmann and Tan Siew Ee, Industrial Growth Employment and Foreign Investment in Peninsular Malaysia, Kuala Lumpur, Oxford University Press, 1980, p.23, Table II.3

scale establishments. But, in 1971 only 9% to 11% of industrial output and employment shares respectively were generated by small scale establishments (see table 2.12 and 2.5). The reverse pattern occurred for larger scale establishments where their industrial output and employment shares rapidly increased from 39% and 27% in 1959 respectively to 66% and 57% in 1971.

The regional imbalance referred to earlier in this Chapter became more pronounced as industry expanded. In 1971 industrial establishments located in the four main states (Penang, Selangor, Perak and Johore) increased from 70% in 1959 to 79% of total establishments in 1971. Gross output and employment shares of the four main states also increased (see table 2.13 and 2.6). The heaviest concentration was in Selangor which alone contributed about 40% of total manufacturing establishments and generated more than 40% of the total industrial output and employment shares in 1971.

In sum, from the period of pre-independence to the present decade the manufacturing sector has proved to be a dynamic element in Malaysian economic development. Unlike many developing countries Malaysia also directed considerable attention to the agricultural sector thus achieving a reasonably balanced pattern of growth with increasing interdependence and complementarity between the two sectors. Although imbalances are clearly apparent they are much less pronounced than in many other countries.

CHAPTER THREE

CHAPTER THREE

DEVELOPMENT OF GOVERNMENT INDUSTRIAL POLICIES IN THE MANUFACTURING SECTOR

From the beginning the Malaysian government clearly identified manufacturing as a dynamic element in its overall growth strategy. This chapter examines three major components of the government's industrialisation policy - fiscal policy, tariff protection and the establishment of industrial estates. The first part of the chapter covers the period up to 1968, whilst the second part is devoted to the period thereafter when important changes took place .

The analysis indicates a rather pragmatic approach by a government which adapted its policies in the light of changing circumstances, especially the willingness of the government to adopt an 'interventionist approach' if it considered that the pace and direction of industrial development was falling short of its expectations.

I. Early Industrial Policies in Manufacturing Sector since 1957 to 1968

After gaining independence, in 1957, it did not take long for the Malaysian government to set up promotional measures to hasten the growth of the manufacturing sector. This effort was especially desirable to reduce dependency on tin and natural rubber which accounted for about 80% of exports and 30% of Gross Domestic Product (GDP) at that time.[1] Dependence on a narrow range of primary commodities led to the instability and uncertainty of government revenue which in turn made it difficult for future development planning. This dependence can be alleviated to some extent by diversifying the economy, hence the emphasis on the growth of the manufacturing sector.

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1. Lee Hock Lock, Public Policies and Economic Diversification in West Malaysia: 1957 - 1970, Kuala Lumpur, 1970, p.28.

Tax incentives were the first measures taken by the Federation of Malaya for the stimulation of industrial development. Initially fiscal incentives were opposed by the World Bank Mission which recommended, that more effective incentives for industrial development were tariff protection and depreciation allowances. In contrast, the government's Industrial Development Working Party came out in favour of tax concessions for pioneer companies. However it could be argued that both parties' recommendations to stimulate industrial growth were not substantiated by any empirical evidence.

Malaysia's development strategy was not exclusively biased to the urban sector only. Both rural and urban sectors were equally emphasised under government development planning. A balanced development strategy should make it relatively easier for government to integrate the agricultural sector with the industrial growth, by providing further linkages between these sectors.

The first major piece of legislation was enacted July 31 1958 in order to accelerate the overall industrialisation by way of relief from income tax. This measure was known as the Pioneer Industries Ordinance 1958 (PIO). Similar measures already existed in many developing countries, such as Barbados, Philippines, Gold Coast, Singapore, Jamaica and Nigeria.[1]

Pioneer status was only granted to the manufacturing companies under certain conditions as follows,

(1) "the given industry either does not exist or only produces on a scale not suitable for the economic or development requirements of the Federation of Malaya.

(2) The prospects for the future potential of the given industry are favourable.

(3) The given industry is considered to be expedient with respect to the public interest and should therefore be assisted."[2]

1. See Report of Industrial Development Working Party, 1957, App. x.
2. See Pioneer Industries Ordinance (PIO) 1958.

Once the above conditions were fulfilled and the production of the companies had begun, the companies were eligible to apply for pioneer status. The length of tax exemption under Pioneer Status in 1958 ranged from 2 to 5 years dependent on the amount of initial fixed capital expenditure. A summarised provision of Pioneer Status 1958 or Pioneer Industries Ordinance 1958 can be seen in diagram I.

Diagram I - Pioneer Ordinance 1958 (A Summary)

Pioneer Status → tax holiday → fixed capital investment

M$ 400,000 - 2 years

M$ 100,000 - 249,000 3-years

M$ 250,000 - 5 years

Source: Federal Industrial Development Authority (FIDA), Kuala Lumpur.

Fiscal incentives, attracted a large number of especially foreign investors and subsequently the number of pioneer certificates issued increased rapidly. However by the mid 1960s it was felt that PIO 1958 provided too generous incentives, especially since the majority of firms which qualified were granted the maximum period of tax exemption. In 1965, therefore, Pioneer Industries Ordinance 1958 was accordingly revised, the main change being an upward revision of the fixed capital requirement, thus tax exemptions were still a direct function of initial fixed capital of the companies. The detailed provision of Pioneer Status 1958 as revised in 1965 are shown in diagram 2.

Diagram 2 - Pioneer Industries Ordinance 1965 (A Summary)

Pioneer Industries Ordinance →	tax holiday →	capital investment
		<M$ 250,000 - 2 years
		M$ 250,000 - 499,999-3 years
		M$ 500,000 - 999,999-4 years
		M$1,000,000- 5 years

Source: Federal Industrial Development Authority (FIDA), Kuala Lumpur.

In Chapter 2, it was noted that one of the disappointing facets of early industrial growth was its uneven distribution, especially the concentration in the few developed states. The situation was further exacerbated by the initial government industrial policy, since the provision of Pioneer Status or Pioneer Industries Ordinance 1958-1965 did not emphasise the need for regional development in the less developed states. Even industrial estates, perhaps one of the more effective measures to attain regional industrial dispersion, were initially established in the developed states. Although with the infrastructural prerequisites already existing in the developed states it is understandable why the majority of industries gravitated around such centres.

The first industrial estates were established in early 1962 in the states of Penang (Mak Mandin), Perak-Tasek, Johore-Larkin and Tampoi. In a second phase industrial estates were established in 1966 in the states of Selangor - Shah Alam (formerly called Batu Tiga) and Negeri Sembilan (Semawang). By 1967, there is a close correlation between industrial estates and the main high income states. However by 1971 some progress is apparent in the establishment of industrial estates in the less congested areas particularly in the less developed states. The later progress of industrial estate development is examined in section II of this chapter.

Industrial estates offered completed developed sites with utilities, good transportation systems and a long-term lease with a land title. Hence it was considerably cheaper for the manufacturer to set up their establishments in industrial estates than elsewhere.

At independence the institutional infrastructure was mainly geared to commerce and trade. However with the introduction of an industrial development programme it was necessary to establish government organisation to cater more specifically to the needs of industry. In 1958 the Development Fund Ordinance was introduced to raise funds for all forms of infrastructural facilities including the purchase of industrial sites. For instance, in the period of 1956-60 the government spent M$ 11 million on industrial sites but most of this expenditure was located in Petaling Jaya. Under Second Malaya Plan (1961-1965) about M$ 7.5 million were allocated to all levels for the similar purpose.[1]

Malaysia Industrial Development Finance Ltd.,(MIDF) was formed in 1960 which marked another important institution for financing the private sector. This institution had an initial capital provision of M$ 15 million in 1960 and by August 1962 the fund was further raised to M$ 50 million.MIDF's specific purpose was to assist both local and foreign investors to accelerate the development of manufacturing activities in accordance with government objectives. MIDF facilities included, medium to long-term loans, purchasing equity, fulfilling underwriting services, extending various other services in connection with and setting up production facilities. Early criticism of the MIDF related

1. International Bank for Reconstruction and Development (IBRD) Report 1963 - Report on the economic aspects of Malaysia by a mission of the IBRD under the Chairmanship of J. Rueff, Singapore Government 1963, p. 29f.

to its bias toward large-scale investors(mainly foreign). This largely derived from the MIDF's preoccupation with profits which unfortunately discriminated against the smaller locally owned enterprises. Such criticisms finally led to reorganisation of MIDF which paid more attention to the small scale establishment rather than large scale establishment.

Malaysian Industrial Estate Ltd., (MIEL) was set up in 1960 with the main aim to reduce the complication in setting up a new factory on an industrial estate in Malaysia. Malaysian Industrial Estate Ltd., (MIEL) is a subsidiary of Malaysia Industrial Development Finance Ltd., (MIDF) which offered

> "standardised factory units or complete, made to order production facilities, which could either be leased or purchased at reasonable prices."[1]

Obviously, MIEL was more biased toward the large scale establishment but this situation was counterbalanced by assisting the small-scale industries which included handicrafts industry etc. since such industries generally were less able to raise capital through orthodox methods.

In the period of early 1960s, there was not much progress of industrial development partly because of lack of coordination between agencies engaged in industrial growth. Such criticism was aired in the Rueff Report[2] which proposed the establishment of an autonomous public industrial agency in order to lessen the complaints of bureaucratic ineptitude. This autonomous body known as Federal Industrial Development Authority (FIDA) was created in 1965. Its main task was to carry out promotional activities both at home and abroad, to undertake industrial feasibility studies, to recommend the establishment of industrial sites

1. Dean Spinanger - Regional Industrialisation Policies in a Small Developing Country, A case study of West Malaysia, Kiel, 1980, p.44.
2. See as interpreted by D. Spinanger, Regional Industrialisation Policies in a Small Developing Country, A case study of West Malaysia, Kiel, 1980.

and process the pioneer status applications. It was, in addition, to be responsible for the coordination of industrial development activities. FIDA also performed special tasks such as making recommendations to the Minister of Trade and Industry on industrial growth issues. These functions were performed only after 1967 because of the slow response from the government. This feature was understandable since in the early formation of FIDA as noted by Heinz Rudolph (1970) was made difficult by the lack of trained Malays, although the skilled expertise of other races already existed.[1]

Tariff protection forms another important pillar of the government's industrial development strategy, although initially tariffs were mainly used to generate revenue rather than as protective devices. For instance, the import duty revenue collected from motor vehicles which at that time were not produced locally, was increasing almost double in their share of total import duty revenue i.e. from 10.1% in 1954 to 17.0%-1956.[2] Other similar examples suggest that Malaysia in its early phase of industrialisation placed less emphasis on tariff protection than many other developing countries. The policy of tariff protection as advocated by the World Bank Mission as a means for stimulation of industrial development was implemented only slowly. This is explained by several factors which included the following: First, the increase of existing tariffs might have led to reduced imports and thus deprived the government of revenue. Second, being a colony until 1957, it was not able to pursue an independent trade policy as it was firmly tied to the commonwealth system. Third, it was feared that tariff protection favoured the urban Chinese at the expense of the poor Malays. This

1. See also D. Spinanger, Regional Industrialisation Policies in a Small Developing Country, A case study of West Malaysia, Kiel, 1980, p40-50.
2. L. Hoffmann and Tan Siew Ee, Industrial Growth Employment and Foreign Investment in Peninsular Malaysia, Oxford University Press, 1980. p.53-54.

would have intensified racial tension, as the income distribution was already unequal. Fourth, under free trade policy, there was a strong opposition from plantation, mining and commercial sectors where input prices would be increased by tariff. This was especially so from the more labour intensive industries such as rubber where tariffs would have increased the cost of living, which in turn would increase the demand for higher wages. Lastly, the Working Party initially favoured tax incentives and was reluctant to use tariffs for a protective purpose.

However a tariff protection institution came into existence in 1959 when the Tariff Advisory Committee (TAC) was established. Despite the establishment of TAC tariffs as instruments for protective purposes were underutilised, since TAC was fairly inactive as an institution. Only a few pioneer industries were granted tariff protection and most of TAC actions were influenced by revenue consideration. In fact by 1962 TAC actually abolished a number of tariffs.

Under Tariff Advisory Board (TAB) Act in 1963, TAB was subsequently fully constituted and this turning point marked the end of tariff policy for revenue purposes to one for protective measures. Therefore, even before 1968,Malaysia's tariff policy changed from tariff making for revenue purposes to active protection. The impact of tariff protection will be analysed under Chapter 4.

To sum up, the general trend of government industrial strategy before 1968 was mainly to maintain a favourable investment climate by providing tax incentives, industrial estates and other industrial infrastructure such as financial institutions.After 1968 the role of indigeneous peoples (included Malay) was increasingly important in influencing the government's industrial strategy. This new strategy was eventually encapsulated in the New Economic Policy (NEP).

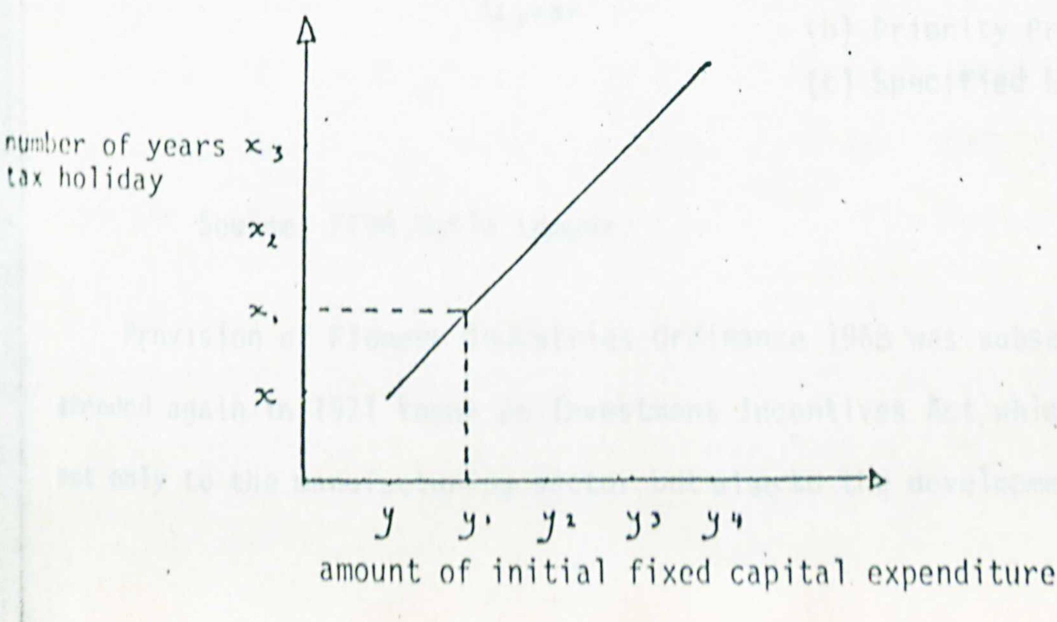
II. Period of Increased Government Industrial Policies Activity from 1968

Fiscal Incentives

Under the Pioneer Industries Ordinance (PIO) 1958, the number of pioneer companies increased from 18 in 1959 to 246 in 1971. Although the number of pioneer companies appeared small, they contributed a considerable share to the manufacturing value added, employment and output. A disappointing facet of the large scale establishment attracted by PIO was its highly capital intensive nature and its inappropriate technology in relation to the problem of unemployment. This particular situation, existed only in the initial stage of industrial growth particularly before mid 1970's.

In 1968 the government enacted a Pioneer Industries Ordinance PIO (1968) which marked a turning point in government industrial strategy. Although the 1968 Act itself did not introduce dramatic change, some of its minor changes later became more significant in government policy. The basic concept of promotional incentives remained unchanged, i.e. the length of exemption was a direct function of capital investment. This is shown in diagram 3.

Diagram 3 - Tax Holiday as a Direct Function on Amount of Initial Fixed Capital Expenditure of a Company.



As shown in the above diagrams, as the initial amount of fixed capital expenditure increases so does the length of tax holidays granted. For instance a company investing y_1 amount of initial fixed capital expenditure, is granted x_1 tax holiday. If a company has a larger fixed initial capital expenditure for instance from y_1 to y_2, the tax holiday granted also increases from x_1 to x_2.

The 1968 Act did however incorporate changes which widened its scope. Commercial enterprises as well as manufacturing firms became eligible for pioneer industry consideration. Furthermore it also granted, an additional tax holiday up to 3 years under certain conditions, as follows, (1) if an industrial establishment set up in a specific development area. (2) used a specified local content and (3) on production of 'priority' product. This provision is summarised under diagram 4.

Diagram 4 - Provision Pioneer Status (PS) 1968 (A Summary)

Pioneer Status → tax holiday 1968

- → fixed capital investment → less than \$250,000 - 2 years
  - not less than \$250,000 - 3 years
  - not less than \$500,000 - 4 years
  - not less than \$1000,000- 5 years
- → additional year → (a) Development area
  - (b) Priority Products
  - (c) Specified Local Content

Source: FIDA, Kuala Lumpur.

Provision of Pioneer Industries Ordinance 1968 was subsequently amended again in 1971 known as Investment Incentives Act which applied not only to the manufacturing sector but also to the development of hotels.

This was in response to increasing demand for hotels and the desire to stimulate the tourist industry. The 1971 Act may be seen as a strategy to broaden and diversify the economy although its methods are not without criticism and these are examined more closely in Chapter 4.

A further change in fiscal policies is seen under Investment Incentive Amendment Act in October 1971 formulated to attract mainly the electronics industry. This piece of legislation revealed the governments attempt to reap spin-off benefits from the increased demand for electronics components in the world market. As far as Malaysia was concerned in the early 1970's it was in a position of comparative advantage since it had an abundant supply of cheap labour. To reap this benefit, Malaysian industrial strategy formulated a 'special investment incentives' which granted privileges up to a maximum of 10 years. This incentive was aimed to encourage foreign investors to set up their labour intensive establishments in Malaysia rather than other countries. The generous package of incentives for electronic assembly industries was to persuade foreign investors in other countries, to invest in Malaysia. For instance in 1973 there was a large-scale movement to Malaysia from Singapore of electronic assembly firms partly in response to Malaysia's offer of 10 years tax exemptions for foreign enterprises which exported their manufactured products. These footloose industries not only exacerbated the regional imbalances since they mostly set up in the West Coast of Peninsula Malaysia but they also paid very low wages which were below the national income per capita.[1] This will be examined further in Chapter 4 and 5.

In 1971, a Labour Utilisation Relief (LUR) was introduced in order to counterbalance the bias toward capital-intensive establishments. Under

1. See "Managed Industrialisation and Poverty Redressal Policies in Malaysia - Ozay Mehmet, The South East Asian Economic Review, Vol. I. No.3, Dec. 1980.

LUR provision a qualified company can be granted tax exemption for a period of 2 to 5 years if it employs a specific number of full-time employees. The schedules ranges from 2 years for 51-100 employees and up to five years for a company employing 351 full time employees or more. Additional years can be granted if the company fulfils other specific conditions. LUR provisions are shown in diagram 5 below.

Diagram 5 - LUR Provision (A Summary)

Labour Utilisation Relief (LUR)
→ employment →
- 51 - 100 employees - 2 years
- 100- 200 employees - 3 years
- 201- 350 employees - 4 years
- 351 and above employees - 5 years.

→ additional year → (1) Development area
(2) Priority products
(3) Specified low content

Source: FIDA, Kuala Lumpur.

LUR provision marked a turning point, to the basic concept that exemption depended on the amount of fixed capital expenditure. How far this provision is effective to attract labour-intensive industries will also be examined in Chapter 4.

In addition to the above fiscal incentives, another type of tax incentive was formulated under Investment Incentive Act 1971. This incentive is known as Investment Tax Credit (ITC) and can be granted to companies which do not qualify for pioneer status but whose establishment is encouraged by government. Amount of Investment Tax Credit given is not less than 25% of capital expenditure incurred on factory, plant or machinery for an approved project. The ITC will be increased by additional 5% if the following condition are fulfilled by a company;

"(1) if the factory is in a development area.
(2) if it attains the required percentage of Malaysian content.
(3) if it produces a priority product ."[1]

A summary of Investment Tax Credit (ITC) provision can be seen in diagram 6. It appears that ITC provisions are favourable for projects with heavy investments and long gestation period before profits are made.

In the late 1960s the Malaysian government became increasingly concerned that industrial strategy should not be dependent on import-substitution industrialisation (ISI) only, but that export led growth strategy should be encouraged further. One of the measures to promote export expansion was a set of fiscal incentives known as export incentives enacted under the Investment Incentive Act 1968. There were three types of export incentives which included the following.

(1) Accelerated Depreciation Allowance (ADA)

(2) Double Deduction for Promotion Overseas.

(3) Export Allowances. The summarised provision of export incentives are shown in diagram 7.

Regional imbalances have led to rural-urban migration which is another challenging problem to political stability. In order to redress these regional imbalances Locational Incentives (LC) were formulated in 1973. Initially this package of incentives did not specifically state the designated area under LC provision. Instead the Minister of Trade and Industry had the power to allow him to specify the areas, as well as

1. Investment Tax Credit (ITC) Provision - Investment Incentives Act 1968, MIDA Publication.

the length of tax exemption and dateline for the application. The summarised provision of Locational Incentive are shown in diagram 8.

Diagram 6 - Investment Tax Credit Provision (A Summary)

Investment Tax Credit (ITC) →

→ Amount not less than 25% of capital expenditure incurred on factory, plant or machinery for approved project.

→ Additional 5% → (1) Development Area
(2) Priority Products
(3) Specified Local Content.

→ Tax relief equal amount to credit, and credit can be carried forward in case of loss or insufficiency of income until fully utilised against subsequent profits.

Source: FIDA, Kuala Lumpur, Malaysia

It was not until 1977 that officially designated area were specifically mentioned.

These were

(1) Kedah excluding Kuala Muda District
(2) Pahang excluding Kuantan District
(3) Kelantan
(4) Trengganu
(5) Perlis

Diagram 7 - Provision of Export Incentives

Export Incentives

- **Deduction for Promotion Overseas** →

  Expenses Qualified

  (a) overseas advertising
  (b) supply of free samples overseas
  (c) Export market research
  (d) Preparation of overseas tenders
  (e) Supply of technical information overseas
  (f) Public relations work connected with exports
  (g) Expenses directly contributable to the exhibits and participation required in trade or industrial exhibitions approved by the Minister of Trade and Industry
  (h) Fares in respect of travel overseas by employees of companies for business
  (i) Accommodation and sustenances expenses incurred by Malaysian business men going overseas for business subject to \$100/- per day.
  (j) Cost of manufacturing sales offices overseas for the promotion of exports.

- **Accelerated Depreciation Allowances** →

  Only resident companies qualified

  Must export 20% by value

  Given only in respect of capital expenditure incurred on modernisation

  rate 40% per annum

- **Export Allowance** →

  Formula used
  (i) for a company which is already exporting

  (a) $x \times 2\%$
  plus (b) $(x-y) \times 10\%$

  (ii) for a company which is exporting for the first time

  $x \times 12\%$

  x = exports in the basis period
  y = export of the year in which the company was last exporting.

Source: FIDA, Kuala Lumpur, Malaysia.

Diagram 8 - Provision of Locational Incentive (A Summary)

Locational Incentive

- → tax holiday
  - → capital investment
    - less than \$250,000 - 5 years
    - not less than \$250,000 - 6 years
    - not less than \$500,000 - 7 years
    - not less than \$1,000,000- 8 years

    or
  - → Employment
    - less than 101 employees - 5 years
    - 101 - 200 employees - 6 years
    - 201 - 350 employees - 7 years
    - 351 - above employees - 8 years
  - → Additional Year
    - (a) Priority Products
    - (b) Specified Local Contents
- → Dividends - Dividends paid out of tax free profits by shareholding companies to shareholders, where shareholder is a company, are exempt from tax in hands of the shareholder.
- → Capital investment → Capital expenditure on existing assets deemed to have been incurred on day following end of tax relief period and capital allowances calculated accordingly.
- → Losses - where losses have been incurred during the tax relief period, the net amount of such losses can be carried forward and offset against income in the past tax period.

(6) Sabah
(7) Sarawak
(8) Johore Tenggara Area

The distribution of Locational Incentive is also seen in map II.

Overall, fiscal incentives were responsible in stimulating the growth of manufacturing production but they also had several shortcomings since the package of fiscal incentives had grown very rapidly and in a haphazard way. The impact of fiscal incentives on the manufacturing sector will be examined more clearly in Chapter 4.

Tariffs

As early as 1963 Malaysia still had a low level of tariff protection, and non tariff barriers were also non-existent. However, by end of the 1960's decade, tariff policy had changed from tariff making for revenue purposes to that of active protection.

In order to speed up the function of tariff policy as a protective instrument a Capital Investment Committee (CIC) was set up in 1969. The Tariff Advisory Board was replaced by the Special Action Committee on tariff which served as a tariff unit operating within FIDA. This was to stimulate the process of tariff protection. Conditions for increased tariff protection included, the output of a firm or its increment to production should sufficiently satisfy a given proportion of the domestic market. Usually in principle this proportion should be 80% but sometimes as little as 40% or 50% was accepted. If the above condition is fulfilled by the firm, the degree of protection is apparently calculated by comparing the cost of production with the prices of imports. The degree of tariff protection also took into account the future possibility of dumping or marginally priced imports. Under certain conditions tariff protection is also based on the excess of the cost of production over the prices of imports. Under this case, permissible price is not related to the cost of imports or the price of efficiency but is only related to the cost of production plus an adequate return to the capital. Temporary quotas besides tariffs are also operated under the recommendation of FIDA. This protection is typically granted for 6-9 months but in some cases it can be longer. This is to avoid stockpiling by importers before the new tariff become effective and also assists the local firms to get an easy start to their production. In 1974, only 80 items imported, were under temporary quotas measure.[1]

Industrial Estates

As mentioned earlier, industrial estates were established mainly in the more developed states including Johore, Penang, Selangor and Perak. No industrial estates were set up before 1970 in the Northern states of Trengganu, Kelantan, Perlis and Kedah. This indirectly exacerbated the problem of regional imbalances with heavy concentration on a few major developed states. Moreover industry was confined to a few major cities within the developed states. To counterbalance this, under Malaysian Industrial strategy, effort were made to increase the number of industrial estate establishments in less developed states. In the period of 1970 to 1974 the overall number of industrial estates increased from 8 to 44 and their area increased by 200% to 13, 995 acres. Moreover the expansion of industrial estates in less developed states especially Northern States (Perlis, Kelantan, Trengganu and Kedah) also increased (see table 3.1). This was a positive approach to locate industrial estates in the less developed states and to redress regional imbalances. How far the effectiveness of industrial estates to correct

1. Kurt Von Rabenau, Trade Policies and Industrialisation in a Developing Country, A case of West Malaysia, Economic Discussion Paper No.55, Regensburg, Germany, University of Regensburg, 1975, table A-1.

Table 3.1 - Regional Distribution of Industrial Estates in West Malaysia

Region	Distribution (Per cent) of								Share of change[a] (per cent)			Percent of IE area[b] used
	Number of IEs				Area of IEs(acres)							
	1970	1974	1977	>1977	1970	1974	1977	>1977	70-74	74-77	1977-	1977
Northern States	-	13.6	15.1	16.2	-	7.2	10.3	15.5	10.4	25.2	29.5	65.9
Southern States	25.0	36.4	34.0	31.1	9.6	34.2	29.5	30.3	45.1	7.2	32.6	73.8
Western States	75.0	50.0	50.9	52.7	90.4	58.6	60.2	54.2	44.5	67.5	37.9	74.8
Total[c]	8	44	53	74	4,301	13,995	16,928	23,118	9,694	2,933	6,185	73.5[d]

a - (change in IE area in region/total change in IE area) 100 - b - (Area sold in IEs/area saleable) 100 - c Actual values d - Average utilization of IEs in West Malaysia.

IE - Industrial Estate

Source: D. Spinanger - Regional Industrialisation Policies in a Small Developing Country, Kiel, 1980. extract from Table 10, p.56

regional imbalances is examined in Chapter 4.

The development of industrial activity in Malaysia has not been without any disappointing facet, including the identification of ethnicity with economic function. In Chapter 2 it was noted that the Malay was the poorest member of society and this partly resulted in racial riots May 1969. These riots caused a fundamental change of strategy which resulted in the formulation of the New Economic Policy (NEP).

Under New Economic Policy (NEP), a new act known as the Industrial Coordination Act was legislated in May 1975 which was a principal legislative effort to direct the participation of 'bumiputra' (indigeneous peoples included ethnic Malays)to control 30% of equity by 1990. The implementation of ICA in 1976 provoked strong criticism and led to a substantial decline in investment activity particularly in the manufacturing sector. For instance, according to the Federal Industrial Development Authority (FIDA) Annual Report 1971 - 1977 the

> "level of approval in 1977 was only half as high as the peak level of 1974 and 40 per cent lower than the 1971 level."[1]

The Industrial Coordination Act (ICA) 1975 was unclear, ambiguous and aroused uncertainties amongst investors, since the act allowed the government to directly alter the employment and ownership structure of existing firms. Whilst the ICA Act 1975 was clearly responsible for a decline in investment due to the uncertainty it created, it can also be argued that some of the decline was in response to the slowing down of world economic activity - a situation to which Malaysia is particularly vulnerable due to the openess of its economy.

The Malaysian government followed a pragmatic approach by amending the ICA in 1977. The new 1977 Act, was drafted more carefully and gave

1. Federal Industrial Development Authority (FIDA) Annual Report 1971 - 1977.

plenty of room for implementation to be flexible. For instance under the new act the Malaysian government was quite happy to accept 100% foreign equity on sophisticated and export oriented enterprises. By adopting a pragmatic attitude the Malaysian government has dispelled many of the fears created by the 1975 ICA Act. Despite the downturn in the world economy, Malaysia has continued to attract a considerable amount of investment both foreign and local, to continue its steady growth of the manufacturing sector and to further the objectives of New Economic Policy.[1] As far as foreign investment is concerned a leading South East Asian bank appears optimistic as indicated by the Chairman of the Hong Kong and Shanghai Banking Corporation,

> "I do not think Malaysia needs to be worried about foreign investment" and Dr. Mahathir also said; "Investors know there is a great potential for a steel mill to serve the domestic and export markets. Many of them are keen to come not only to build a steel mill for us but to participate in its equity. With so many interested parties, we can pick and choose who we want to invest in our country, whereas we did not have this option before."2

The political and economic stability of Malaysia is also a significant factor in ensuring a steady flow of investment and therefore

1. The overriding objective of the NEP adopted in 1971 is to achieve national unity through a two-pronged development strategy of:
(1) eradicating poverty by raising the income levels and increasing the employment opportunities for all Malaysian irrespective of race and
(2) restructuring society as to reduce the economic imbalances that exist among the various races in Malaysia and to eventually eliminate the identification of race with economic functions."

See <u>Third Malaysia Plan</u> 1976 - 1980, Malaysia Government Publication.

2. Article on "the right to choose investors" from our Special Correspondent <u>Country Perspective Malaysia</u>, Malaysia Government Publication 1980's.

manufacturing development. For instance foreign investors do not fear nationalisation and Malaysia has a good reputation for honesty and lack of corruption.

This chapter has outlined major changes in industrial development policy since independence in 1957. The next Chapter looks more closely at the impact of these changes.

CHAPTER FOUR

CHAPTER FOUR

THE IMPACT OF MAJOR INDUSTRIAL POLICIES ON THE MANUFACTURING SECTOR IN MALAYSIA

The major industrial policies in Malaysia are tariffs, fiscal incentives and industrial estates. The two main pillars on which Malaysian industrial strategy is based are tariffs and fiscal incentives. These two instruments have been used to stimulate the growth of manufacturing sector, even though there has been considerable controversy in regard to their effectiveness. Nevertheless, tariffs and fiscal incentives were equally used in Malaysian industrial strategy in order to hasten the development of manufacturing activity. Another major problem in the development of industrial activities in Malaysia was the concentration of activity in a few developed states. One of the difficult tasks of industrial planning is to direct industrial activity into less developed states thus aiming to redress uneven regional development. To achieve this aim, industrial estates were used as an instrument of regional development. This chapter, assesses some of the impact of these major industrial policies, particularly fiscal incentives, tariff protection and industrial estates.

Section I - Fiscal Incentives

In the previous chapter, it was noted that since 1970, government industrial strategies stressed the need for export orientation rather than import substitution. This was partly because import - substitution opportunities were becoming exhausted and export - led growth was necessary to sustain further industrial growth. Efforts to gear the manufacturing sector toward export orientation were seriously considered only after 1968 with the launching of the Investment Incentive Act 1968. Most of the government's promotional industrial policies for export orientation only became effective in the 1970's decade, correspondingly export expansion of manufactured goods increased from 11% of GDP in 1970 to 21% in 1980. (This is shown in Table 2.7, Chapter 2). The relatively good performance of the manufacturing export sector was partly attributed to the government's industrial policies including fiscal policies. Fiscal incentives include the double deduction of export promotional measures which range from overseas advertising, supply of free sample overseas, export market research, preparation of overseas tenders, supply of technical information overseas, public relationswork connected with export and accelerated depreciation allowance (ADA). These fiscal incentives form part of the government's industrial strategies to accelerate the growth of manufacturing activities.

Although there are many factors, fiscal incentives are a main factor responsible for the growth of manufacturing export sector in Malaysia and indeed other newly industrialising countries such as Singapore. According to one researcher,

> "while many factors are responsible for the spectacular growth of Singapore's manufacturing industry, tax incentives must be considered one of them".[1]

However Hoffmann argues that tax incentives were redundant in the sense that they did little to influence investment activity. Such an argument is clearly stated by Hoffmann,

> "the empirical evidence is that tax incentives are largely redundant ...." and he further proceeded and concluded that, "in the light of this it is rather surprising that in the HEX it was the smaller rather than the larger firms which considered tax incentives as important for their export activity. It could well be that the large companies did not consider that the incentives had a decisive influence on their activity but nevertheless reaped their benefits,"[2]

1. A.D.Fong, Strategy of Economic Development in Singapore(Singapore 1970) p.48
2. L. Hoffmann and Tan Siew Ee, Industrial Growth, Employment and Foreign Investment in Peninsular Malaysia, p.50, Oxford University Press 1980.

It could be argued that Hoffmann's analysis to prove tax incentives as ineffective is questionable. This is because some of the evidence, and to some extent Hoffmann's empirical evidence as shown in table 4.1 can be used to show that tax incentives have played a positive role to determine investment activity in the Malaysian manufacturing sector. Based on table 4.1 in general the percentage of total approved companies under tax incentives gradually decreased in time, whilst non-incentives approved companies gained in importance especially in 1974. Hoffmann stresses that the incentives through acquired time, played little role to determine investment activity. However it could be argued that through acquired time, it is understandable that many approved companies should not be granted concessions since they are in position to survive under marke competition. As many approved companies are not granted incentives at the later stage of their operation this will increase, the percentage of the total companies without incentives. For instance, from table 4.1 (from Hoffmann's source) the percentage of approved companies without incentives increased from 14% in 1969 to 58% in 1974.

In addition, based on the same table 4.1, as early as 1969 more than 80% of approved companies were granted pioneer status. The contribution of pioneer establishments to manufacturing output, value added and fixed capital stock was significant[1] for instance, the pioneer establishments in 1968 generated more than 29% of the total share of manufacturing value added, output and fixed capital expenditure. The considerable contribution of pioneer establishment to the share of the manufacturing secto was partly attributed to pioneer status policy. Therefore it is an undeniable fact that fiscal incentives played a role to hasten the growth

1. See for detail in Chapter 2 - Table 2.2.

of manufacturing activity. In other words it can be argued that Hoffmann totally misinterprets the value or purpose of tax incentives i.e. if they are designed to <u>initiate</u> industrial development and are successful

Table 4.1 - Percentage Distribution of Number and Proposed Called-up Capital of all approved Firms

(in Per Cent)[a]

YEAR	Pioneer Status		Investment Tax Credit		LUR		Other Incentives[b]		No Incentives	
	No.	Capital	No.	Capital	No.	Capital	No.	Capital	No.	Capital
1969	83	92	3	3	0	0	0	0	14	5
1970	52	70	9	12	0	0	1	0	38	18
1971	48	54	7	19	0	0	6	17	39	10
1972	45	69	3	11	2	3	2	1	48	16
1973	38	69	5	9	4	2	3	2	50	18
1974	32	60	6	13	3	1	1	1	58	25

N.B.: a - Figures add up horizontally to 100 for No. and Capital respectively

b - Includes accelerated depreciation allowances

LUR = Labour Utilization Relief

Souce: L. Hoffmann, T.S. Ee - Industrial Growth, Employment and Foreign Investment in Peninsular Malaysia, Oxford University Press 1980. Table III,6, pg. 49.

in so doing, then they will no longer be required and therefore should be expected to become redundant.

But, how far are tax incentives the most effective instruments to determine investment activity? This is still questionable, since tax incentives are not the only single industrial instrument to determine investment activity. This is because other major factors such as political and economic stability plus Malaysia's resource endowment contributed positively in determining investment activity but such factors are difficult to quantify. Nevertheless, tax incentives can be a complementary instrument to hasten and determine the pattern of industrial activity.

The impact of certain fiscal policies has been considered as undesirable by some observers. In particular the Special Incentives for Export Orientated Industries. This incentive was especially designed to attract both labour intensive and export oriented industries. By 1973, Malaysia was successful in attracting these industries as seen from the large-scale movement, mainly electronic assembly industries, from Singapore. Besides, electronic assembly industries, other export manufacturers equally as important were textiles and clothing. These incentives generated a substantial increase in manufacturing's share of Gross Domestic Product (GDP), from 16.4% in 1975 to 19.8% in 1978. More significantly these industries also accounted for almost one

Table 4.2 - Total Employment Share in Selected Manufacturing Industries

Industry	1973 (June)		1979 (June)	
	(No.) Employees	as % of total	(No.) Employees	as % of total
Electronics	12,316	7.7	65,949	22.3
Textiles	17,425	10.9	34,533	11.7
Clothing	7,846	4.9	16,307	5.5
Total[a]	37,587	23.5	116,789	39.5
Total Manufacturing	159,259	100.0	296,378	100.0

a - total of the three selected industries.

Source: Computed from Ozay Mehmet, Managed Industrialisation and Poverty Redressal Policies in Malaysia, South East Asian Economic Review, Vol. 1, No.3, 1980, p.225, Table III.

third of aggregate output growth in the entire economy.

The growth of export - oriented industries based on cheap labour generated a considerable employment share in the manufacturing sector. Table 4.2 indicates that 40% of total employment in the manufacturing sector was contributed by electronics, textiles and clothing industries. These industries were attracted to set up their branch-plants in Malaysia mainly in response to government industrial policies especially the Special Incentives which granted up to a maximum ten years of tax holiday are unfortunately 'footloose' industries. As their name implies these industries seek out countries with the most generous tax incentives and cheap labour availability, and are prepared to move on after taking advantage of such conditions. In the 1980s Malaysia's comparative advantage in cheap labour is gradually being eroded and there are signs that these footloose industries might be moving to other developing country such as Thailand & Sri Lanka which have large supplies of cheap labour and generous packages of tax incentives. This is suggested by Ozay Mehmet,

> "Some years ago, they were dominant in Singapore but economic growth and land shortage there have forced the Singaporean authorities to become increasingly selective and dependent on labour-saving high-technology. Malaysia has reaped some spin-over benefits from this, but now there are signs that these firms are moving into Thailand and Sri Lanka and other sources of cheap labour."[1]

How far do Special Incentives effectively fulfil some of the government's objectives to narrow the gap of income inequality and to uplift living standards of society through skill-training and man-power

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1. Ozay Mehmet, Managed Industrialisation and Poverty Redressal Policies in Malaysia, The South East Asian Economic Review, Vol. 1, No.3, Dec. 1980, p.226.

development? In order to assess the above government objectives, it is necessary to examine some of the footloose industries' features. One feature is that they do not require many skilled workers since the manning of automated machines and assembly line operations in electronic - assembly industries can be easily done by any workers with little or no educational qualification. Hence, these footloose industries are not good agents of technology transfer since it is not necessary for them to invest in skill-training and man-power development. This aspect may be seen as inconsistent with the government's aspirations to modernise and restructure the economy and society in Malaysia.

Although labour productivity in these footloose industries is high, workers in these industries are lowly paid and the majority earn "a monthly income well below the average national income per capita of M$217 per month"[1]. This evidence suggests that footloose industries are not successful as an agent to uplift the living standards of a poor society which is trapped in a vicious circle of poverty. In the past, rapid urbanisation in Malaysia has been accompanied by the considerable growth of slum and squatter areas. This is a sign of increasing net social costs, as the growth of footloose industry is inconsistent with government objectives. In addition as observed by one researcher i.e..

> "yet the electronics factories especially have trouble finding workers and the largest factory has to attract its workers from over a wide area, even from the state of Kelantan"[2]

With this evidence there is a need to have new industrial policies which not only aim to broaden the industrial base but also uplift the standard of living among the poor by narrowing the income inequality gap.

1. Ozay Mehmet, Managed Industrialisation and Poverty Redressal Policies in Malaysia, The South East Asian Economic Review, p.226.
2. Anton Van Naersen, Location Factors and Linkages at the industrial estates of Malacca Town. Research Notes and Discussion Paper No.16, 1980, Inst. of South East Asia Studies, Singapore.

It is also worth assessing the impact of Labour Utilization Relief (LUR) which is especially aimed to attract labour-intensive industries. Labour-intensive industries were especially appropriate before the 1980's decade because of unemployment problems amongst the unskilled workers. From table 4.3 only a few approved companies were granted privileges under Labour Utilization Relief (LUR) incentives. In fact, over a period of time, as seen in table 4.3 the percentage of approved companies under LUR incentive were decreased. For instance, in 1972 total approved companies under LUR incentive were 9% but by 1976 only 7% of total approved companies came under this incentive.

At the first glance, LUR incentives are different from other fiscal

Table 4.3 - Percentage of Total Approved Companies under LUR Incentive from 1972-1976.

YEAR	1972	1973	1976
No. of approved companies	355	473	425
No. of companies granted LUR (percentage)	9	17	7
No. of total authorised Capital (percentage)	2	2.7	0.6

Source: extracted from Federal Industrial Development Authority (FIDA) Reports 1972, 1973 and 1976.

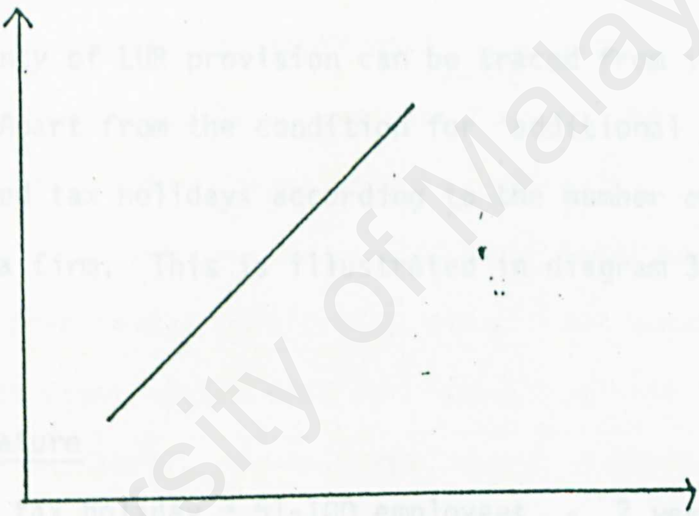
incentives such as Pioneer Status (PS), Investment Tax Credit (ITC), Accelerated Depreciation Allowance (ADA) and Special Incentive (SI). Generally, the length of tax holiday in most fiscal incentives is dependent on the amount of initial fixed capital expenditure of a company. Hence, tax holiday is a direct function of the amount of initial fixed capital expenditure of a company. In contrast LUR incentives are dependent on the numbers of full time workers not the amount of initial fixed capital expenditure of a company. This is demonstrated in diagram I and II.

Labour Utilization Relief (LUR) incentives are supposed not to be

<u>Diagram I</u>

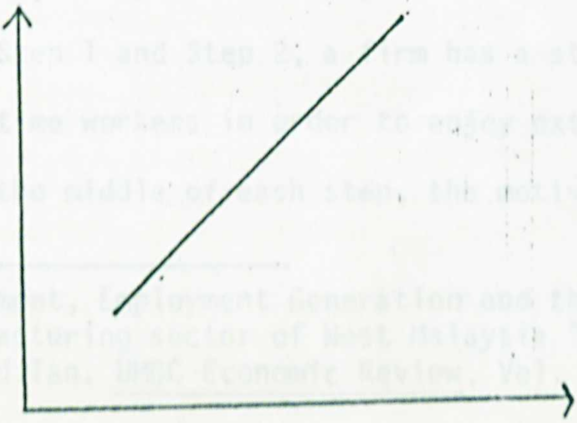
<u>Tax holiday is a direct function of the amount of initial fixed capital expenditure</u>

- Accelerated Depreciation Allowance, Pioneer Status, Investment Tax Credit and Special Incentive



<u>Diagram II</u>

Tax holiday is <u>not a</u> direct function of the amount of initial fixed capital expenditure - Labour Utilization Relief (LUR) incentives



biased toward capital intensive industries. However in practice this does not appear true. Based on the 1968 Census of Manufacturing, firms employing less than 51 full time workers accounted for 94% of total number of industrial establishments which in turn were classified as labour-intensive industries (this is measured in terms of fixed asset per worker).[1] Since establishments with less than 51 full time workers were excluded from LUR incentive provision it can be argued that LUR provisions discriminated against the medium and small sized establishments which form the bulk of labour-intensive industries.

Another deficiency of LUR provision can be traced from its 'step function' feature. Apart from the condition for 'additional years' LUR incentives granted tax holidays according to the number of full time workers employed in a firm. This is illustrated in diagram 3.

Diagram III

LUR step function feature

Labour Utilization → tax holiday →	51-100 employees	- 2 years	(Step 1)
	101-200 employees	- 3 years	(Step 2)
	201-350 employees	- 4 years	(Step 3)
	351-More employees	- 5 years	(Step 4)

Labour Utilization Relief Incentives deficiency revealed by 'step function' feature is argued by Teh Kok Peng. At the margin of the step for instance between Step 1 and Step 2, a firm has a strong motivation to employ extra full time workers in order to enjoy extra one year tax holiday. However in the middle of each step, the motivation of a firm to

1. See Foreign Investment, Employment Generation and the Profit - Wage Ratio in the Manufacturing sector of West Malaysia "a reply to Prof. Hirschman by Gerald Tan. UMBC Economic Review, Vol. XV, No. 1, 1979.

employ more workers is very low since a large number of extra full time workers is required in order to enjoy an extra tax holiday of one year. At the end of the step i.e. Step 4, a firm's motivation to employ more than 351 full time workers is very low indeed, since a firm is still granted a maximum of five years tax holiday.

Locational Incentives (LC) were also introduced and were especially designed to redress regional imbalances. Apart from other conditions, provision of locational incentives stated that to qualify a firm must locate in the less developed states. Based on the findings of Federal Industrial Development Authority (FIDA) Report 1973 locational incentives were ineffective to attract investors into less developed states. For instance in 1969 about 80.3% of total approved companies were located in four developed states. After a 10 year period, only 12% of total approved industries in less developed states were granted concessions under locational incentives.[1] Moreover, the government's task to redress regional imbalances was aggravated by foreign investors. For instance, based on table 4.4 89.2% of total foreign investment was located in the four developed states, whereas local investment was somewhat more dispersed. The tendency for foreign investors to set up their establishments in the four developed states was understandable as foreign investors were generally involved with capital intensive industries which demand sophisticated industrial infrastructural facilities which were readily available in the more developed states particularly in Selangor, Perak, Johore and Penang. It appears therefore that fiscal incentives formulated under the Investment Incentive Act 1968, attracted inappropriate technology which was

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1. An appraisal of the Incentive Schemes for Foreign Investment in Malaysia - M. Abdullah, p.10, Development Forum, Vol. X, No. June 1980.

Table 4.4 - Location of Manufacturing Industries - by state and ownership 1973

(in percentage)

OWNERSHIP / STATE	No.of Local	% of Local	No.of Foreign	% of Foreign
SELANGOR	2767	26.7	276	40.4
PENANG	1540	14.8	65	9.5
PERAK	1901	18.3	43	6.3
JOHORE	1232	11.9	226	33.0
		71.7[a]		89.2[a]
N.SEMBILAN	417	4.0	20	2.9
MALACCA	412	4.0	17	2.5
PAHANG	503	4.9	8	1.2
KEDAH	785	7.6	12	1.7
KELANTAN	411	3.9	13	1.9
TRENGGANU	322	3.1	4	0.6
PERLIS	86	0.8	-	-
TOTAL	10,376	100.0	684	100.0

N.B. a - Total percentages of 4 Developed States

Source: Compiled from Department of Statistics, Census of Manufacturing Industries. Peninsular, Vol. 1 Government Printer, K.L., 1973.

inconsistent with government objectives in the 1970s to create more jobs. Generally, fiscal incentives provision were biased against the small and medium sized establishment. This is partly because fiscal incentives favoured the capital intensive industries which generally are large - scale establishments, Teh Kok Peng argues, that firms choose capital intensive rather than labour intensive establishments because the nature of fiscal incentives provision motivated to such action i.e.

"the tax holiday would be a factor for firms with fixed investment of around and below $1,000,000. That it has influenced as many as four firms out of a sample of fifty-two (even smaller, excluding those with fixed investments much greater than $1,000,000) in their choice of equipment seems to make its capital intensity bias important enough for action to correct it".[1]

This situation calls for government attention to introduce a new industrial policy which provides equal footing for the small and medium sized firms to progress and contribute to the development of ancillary industries in the future.

Moreover, fiscal incentives in attracting foreign investment also accentuated the bias toward capital intensity. This is observed by Gerald Tan,

"The basic point is that foreign owned companies tend to use more capital intensive technology than do local firms. This is true for the entire manufacturing sector as well as almost every specific industry within manufacturing. For every dollar of investment or for every unit of output, foreign firm create fewer jobs than local ones."[2]

Another criticism of fiscal incentives is that in their implementation there was a distinct lack of clear cut criteria in regard to eligibility, which in practice favoured the capital intensive larger establishments which often qualified for privileges under several incentive schemes. This is stressed by Teh Kok Peng,

"the criteria for enjoying the Pioneer Industry Incentives are rather broad so that of the eligible firms, some for example, would be eligible for ITC as well, and vice versa, the same applies for LUR and the ADA. Put differently, the lack of clear cut criteria between incentives means that more firms would in principle be eligible for most or all of them."[3]

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1. Ten Kok Peng, Protection, Fiscal Incentives and Industrialisation in West Malaysia since 1957, Kuala Lumpur, University of Malaya, 1977, p.120.
2. Foreign Investment, Employment generation and the profit wage ratio in the manufacturing sector of West Malaysia by Gerald Tan UMBC Economic Review, Vol. XIV, No.2, 1978, p.30.
3. Teh Kok Peng, Protection, Fiscal Incentives and Industrialisation in West Malaysia since 1957, Kuala Lumpur, University of Malaya, 1977, p.179.

In addition, the lack of explicit criteria allows greater possibilities for a firm to engage in lobbying and other form of rent-seeking activities which offer scope for corruption. If such illegal activities exist it will involve a resource cost to society and also will create bureaucratic ineptitude. Possibility for greater rent-seeking activities is clearly remarked by Teh Kok Peng i.e.,

> "the lack of explicit criteria again confers greater discretionary power on government officials. Firms uncertain of their eligibility for a particular incentives or any incentives at all would be motivated in lobbying and other rent-seeking activities as long as the expected benefits exceed the cost (including the bribe payments). We have the usual resource costs of such activities and the discrimination against the smaller firms."[1]

Efforts should be reoriented to reform the fiscal policies, which could meet the needs of government priority development projects. For instance, in the Fourth Malaysia Plan (1981 - 1985) the government has identified the need to have more linkages within the manufacturing sector. One way is by the establishment of import-substitution on investment goods or capital goods. This has led to the formation of HICOM (Heavy Industries Corporation of Malaysia) which ensures further upstream and downstream linkages in the manufacturing activities. However, at present, it is constrained by the shortage of skilled manpower and to achieve this development process, fiscal incentives could be granted to investors which more specifically fall in line with the government's aspirations.

Malaysia also needs to strengthen further the techno-economic base in the economy in order to generate integrated industrialisation and this could be complemented by formulating incentives granted to investors

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1. Teh Kok Peng, Protection, Fiscal Incentives and Industrialisation in West Malaysia since 1957, Kuala Lumpur, University of Malaya, 1977,p.180

who could achieve these viable development projects. This requires a more selective approach in the government's administration in order to welcome the 'quality' investors who would provide skill development, manpower training and linkages within the sectors. Special incentives, which are mainly granted to footloose industries need to be revised, in order to reflect government priority development projects. A reform of fiscal incentives must not neglect the contribution of small and medium size establishments to the growth of the manufacturing sector and this equally applies to tariff protection policy which is examined in the next section.

Section II - Tariff Protection Policy

As mentioned in Chapter 3, in the preindependence days tariff policy mainly served as a revenue instrument and the domestic market was virtually unprotected, particularly under a system of Commonwealth Preferences.

As Malaysia embarked upon an industrialisation policy based upon import substitution tariff protection became more important, although in the initial stages protection was somewhat less than many other developing countries at a similar stage of development. It is not until the second half of the 1960s that tariffs become established as effective protective instruments. Gradually an increased number of industries were granted tariff protection such as various food type industry, chemical and chemical products industry, basic metal industry, non-metallic products industry, metal products industry and miscellaneous industry.

According to Balassa's calculations nominal protection rates of West Malaysia in 1965 were 9% for primary goods production and 8% for manufacturing, while the effective protection rates were 8% and 11% respectively. In contrast in the Philippines, based on the same year the nominal rates of protection on primary goods and manufacturing activity were 22% and 29% respectively, while effective protection ranged from 14% in primary goods production to 53% for the manufacturing sector.[1] Whilst Philippine rates of protection may have been unduly high it is quite apparent that Malaysian rates were unusually low. Undoubtedly the vested interests of the rubber and tin mining sectors were persuasive in restraining tariff rates, but it appears that the Malaysian government was clearly aware of the problems associated with unduly high tariff protection, especially the problems of inefficiency and monopoly profits. A conscious effort of the government to have a low protection rate was clearly laid down in the First Malaysia Plan (1966 - 1970);

> "the government, however is intent on ensuring that no more protection than is necessary will be accorded for the cost of industrialisation to the domestic consumer must be minimised. The government is also intent that tariff protection will not be afforded for periods longer than are absolutely necessary. The growth of the industrial sector in the long-run will demand that eventually production be extended to supply not only the domestic market but also markets overseas. This makes it essential that domestic enterprises be constantly prodded to increase efficiency so that there will be progressive reduction in production costs."[2]

Several studies have examined the levels of tariff protection in Peninsular Malaysia, these include Edwards, Power, Ariff and Von Rabenau. The results of these studies are summarised in table 4.5 and indicate a substantial increase in tariff protection by the early 1970s.. Although

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1. Bela Balassa and Associates, The Structure of Protection in Developing Countries (Baltimore), Johns Hopkins Press, 1971, p.54.
2. First Malaysia Plan 1966 - 1970, Malaysia Government Publication, p.132 - 133.

results are not consistent with each other, due to differing methodologies it is quite evident that Malaysia transformed itself from a low tariff country in the early 1960s to a fairly highly protected country by 1970.

Nominal Protection Rate (NPR)tends to understate the level of protection given to the final product which mainly influences the consumer's decision. However, the Effective Protection Rate (EPR) reveals the extent of protection given to the production process which affects the investors' decision and hence resource allocation. Effective Protection Rate (EPR) can be measured under the Corden method or Balassa method. Generally the Corden method will reveal lower effective protection than the Balassa method. This is because the Corden method, treats non-traded inputs as primary factors which form part of the value added which is therefore higher but yields lower effective protection On the other hand, the Balassa method, treats non-traded inputs as trade inputs with zero tariffs.

From table 4.5 it is clearly seen that Peninsular Malaysia's nominal and effective rates of protection have substantially increased in the 1960s. For instance in 1965 nominal rates increased from 9% (Power) to 18% in 1970 (Ariff) and 23% in 1973 (Von Rabenau). Evidence of escalating tariff rates in the manufacturing production process is shown by effective rates of protection. For instance the effective protection rate (under Corden method) increases from 12% in 1965 (Power) to 38% in 1970 (Ariff) and 39% in 1973 (Von Rabenau). This suggests that the manufacturing sector in Peninsular Malaysia was generally looking more toward import-substitution rather than an export-led growth strategy. This fairly rapid transition to protection appears to have taken place in a rather ad hoc manner with little attempt at rational or coordinated